INFORMED BUDGETEER

HOUSE ISTEA & LEMON!

- This week the House Transportation and Infrastructure Committee begins its work on the reauthorization of ISTEA. The Committee appears to have no intention of complying with the recent Budget Agreement.

Comparison of House ISTEA and Budget Agreement
(Highway & Transit, Dollars in Billions)

	1998	1999	2000	2001	2002	Total
Contract Authority						
BBA Levels	29.8	28.5	29.1	29.7	30.4	147.5
House ISTEA[a]	30.0	34.2	38.2	39.3	40.5	182.2
Increase over BBA	0.2	5.7	9.1	9.6	10.1	34.7
Spending						
BBA	25.8	26.2	26.6	27.1	27.6	133.3
House no limit (1)	30.4	34.5	38.4	39.6	40.8	183.7[b]
House w/limits (2)	28.0	31.7	35.2	36.3	37.4	168.6
BBA v. no limit (1)	4.6	8.3	11.8	12.5	13.2	50.4
BBA v. limits (2)	2.2	5.5	8.6	9.2	9.8	35.3

[a]The House ISTEA bill authorized contract authority for three years. SBC staff has estimated contract authority and spending for years four and five, assuming inflation from the bill's 2000 year level, consistent with CBO's methodology.
[B]The aggregate number for House spending is slightly higher than the total amount of contract authority due to this figure including -- in addition to contract authority -- general fund spending of $1.5 billion.

- The House bill would exceed the Agreement by authorizing all five years of highway and mass transit contract authority given to them in the Budget Agreement over the next three years.

- Contract authority is a form of budget authority which allows states to enter into contracts for future spending from the Highway and Mass Transit trust funds. Contract authority targets have been set in the Budget Agreement and allocated to the House and Senate committees which have ISTEA jurisdiction.

- Spending is generally controlled by the Appropriations Committee through obligation limitations on available contract authority. In addition, spending includes mandatory spending that is exempt from obligation limitations, such as the Minimum Allocation and Emergency Relief.

- The consequences of the House is to authorize approximately $182 billion in contract authority over the next five years for transportation spending -- $35 billion above the Budget Agreement. Additionally, spending may actually rise to $40 billion above the Budget Agreement when new mandatory spending is made available for highway demonstration projects .

- If all contract authority in the House bill is made available to the states without limitation, an additional $50 billion in new spending levels above the Budget Agreement would result.

- The proposed House bill does provide limitations on the amount of contract authority states can spend in any given year. (The skeptic might ask why authorize more contract authority to spend filling up state coffers, if you are then not going to allow them to spend it?) Nevertheless, setting a obligation limitation on states restricts the actual amount of contract authority that is available to the states to $169 billion over the next five years. Using this figure, an additional $35 billion in spending would result above the Budget Agreement -- not counting demonstration projects.

- If the Appropriations Committee chooses to fund the higher House bill level, any additional spending over the Budget Agreement will have to be offset by further reductions among other discretionary spending programs such as education, the environment and health.

- Current aggregate spending caps in the agreement limit annual discretionary spending growth to 0.6% annually -- less than inflation over the next five years. SBC staff estimate that if transportation is funded at the level of contract authority requested by the House Transportation Committee with no obligation limitations, all other non-transportation discretionary spending would decline by 3.4% annually --after accounting for inflation-- in order to fully fund the proposed levels in the House bill while maintaining the Budget Agreement.

- Even if the obligation limitations in the House bill are enacted, non-transportation discretionary spending would still decline 3% annually, after accounting for inflation.

- The House bill also breaks the Budget Agreement by exceeding its allocation for mandatory outlays for certain highway programs, including highway demonstration projects and Minimum Allocation. The bill also has included language taking the transportation trust funds off-budget.

FEDERAL PAY RAISES SET

- The President announced federal civilian pay raise levels of 2.8% during the August recess, which is the same level assumed in the President's budget and the budget agreement. This level is comparable to the increase proposed for members of the military which will likely be enacted in the Defense Authorization Act.

- Under current law, federal civilian employees would receive a two-part pay raise in January 1988: (1) a 2.8% base salary raise linked to the Employment Cost Index (ECI); and (2) a locality pay raise costing about 7.2% of payroll, based on a BLS survey of non-federal pay in local pay areas.

- However, current law also gives the President authority to implement an alternative pay adjustment if deemed necessary. Because the full statutory increase of 10% would cost about $7.9 billion in 1998 alone, the President has determined that it would violate the budget agreement or force deep cuts in discretionary spending, neither of which is acceptable.

- Most of the 2.8% increase will be allocated to the base salary increase because many federal civilian employees do not receive locality pay. Basic pay will be increased by 2.3% and locality pay will be about 0.5%.

- This pay raise will apply to all federal pay systems that are linked to the General Schedule (GS) unless changed in legislation (such as the Members' pay freeze in S. 1023).

STUDIES & REPORTS

CBO'S REVIEW OF CONSUMPTION TAXES

- In response to a request from Senator Domenici, CBO recently released a study entitled "The Economic Effects of Comprehensive Tax Reform". It examined how a shift from today's income tax system to a comprehensive consumption-base tax would impact savings, growth, the composition of output and economic efficiency.

- On balance, CBO's analysis showed that such a tax shift should have positive economic impact, increasing GDP by 1-10%. The main driver behind this growth comes from an expected increase in savings in response to the higher after-tax rate of return to savings. Labor supply might also be boosted slightly, this would depend on the tax base being broadened enough to permit lower marginal tax rates on labor.

- CBO noted that the rate of GDP growth is unlikely to be boosted permanently. However, it would be higher during the transition period, as GDP rises to its new higher level. It is important to note that this transition period could be expected to extend many years beyond the implementation date of a comprehensive consumption tax.

- CBO stressed that the positive economic impact of the shift to a consumption tax could be eroded by the imposition of any transitional relief, this would necessitate a narrower tax base and higher tax rates to maintain revenue neutrality. The economic impact might also be smaller than anticipated since there are already some tax advantages for savings in the present tax code.

- CBO states that a switch to a consumption tax would have considerable impact on the composition of output. One would expect a shift out of currently tax-preferred vehicles, leading to a more efficient allocation of resources. Within society, the young would be likely to fare better than the old, since the latter consume more of their incomes.

ON THE WAY TO THE AUCTION

- What if the federal government held an auction of spectrum licenses (known as the Block C auction) in which the winning bids were $10 billion? -- you would think that the bidders would walk out of the Federal Communications Commission (FCC) with their licenses after having wired $10 billion in cash to the US Treasury, end of story.

- Not so fast. Winning bids in the Block C auction, held in 1995 and 1996, were indeed $10 billion, but as told in a recently released CBO Memorandum, *Impending Defaults by Winning Bidders in the FCC's C Block Auction: Issues and Options*, the rest of the story is not so simple.

- Because the Congress directed the FCC to experiment with an auction process that would stimulate the participation of small businesses and other businesses limited by past discrimination, the FCC shut out large companies. In addition, the FCC allowed eligible bidders to put only 10% down, rather than pay the whole amount of the bid up front in cash as has been the practice in all other spectrum auctions. The C Block bidders were required to pay interest only on the remaining 90% of the bid for the next six years, with interest and principal for the following four years--so that the whole amount of the bid would be paid after 10 years. Sounds like a loan, doesn't it?

- In fact, CBO and OMB decided that the provisions of the Federal Credit Reform Act applied to this situation, and they determined that the FCC was making a loan to the winning bidders in the amount of 90% of the winning bid. And when the bidders signed the promissory note that allowed them access to the spectrum license, the government recorded the amount of the loan as cash received by the Treasury. In addition, the government recorded in a mandatory program subsidy account a subsidy cost of nearly $1 billion, and planned to record in an off-budget financing account the cash flows resulting from the expected interest and principal payments.

- Most of the bidders appeared to have overbid, cannot obtain financing to build out the infrastructure needed to put the licenses to productive use, and therefore cannot make their promised payments. Because the expected recovery on the loans would produce lower payments than promised in the original loans (either through a negotiated workout with the bidders or through a reauction of the recovered licenses), the budget will have to record the increased subsidy experienced on the loans sometime over the next several years. CBO estimates that this increased amount could be in the $4 billion to $6 billion range, all of which would be an increase above current projections of the deficit for the next few years.

ECONOMICS

EMU AND THE US

- Europe is scheduled to begin its monetary union (EMU) as of January 1, 1999. While much work has been done on its likely impact within Europe, less has been said about its potential impact on the global economy.

- There are many possible channels for its global impact -- the European Central Bank's monetary stance will have significant bearing on global growth and inflation trends, while international trading patterns will likely be affected as well. However, one of the more interesting questions concerns EMU's potential impact on global portfolio flows.

- At present, the US dollar is over-represented in global financial flows. IMF statistics show that roughly 60% of global foreign exchange reserves are held in dollars, while Bank of International Settlement data show 40 % of all foreign exchange transactions involve the dollar. This compares with the 26% share of the US in world GDP and roughly 15% share of world trade.

- The dollar's dominance is partly because the US' capital markets are well-developed. Our stock market capitalization is over 3 times as large as that of the likely 11 nation EMU, while the stock of US debt securities is one and a half times as large. Investors prefer to place money in liquid and heavily traded markets.

- However, the advent of Europe's unified currency (the euro), is likely to improve Europe's standing in the world capital markets. With a population and GDP similar to the US, EMU could develop financial markets which are capable of absorbing greater portions of world investment flows. Indeed, the Institute for International Economics (IIE) estimates that there could be portfolio shifts of $475 billion to $900 billion into the Euro. This is equivalent to 4.5 to 9% of the US fixed income capital market.

- Such inflows into the Euro could only materialize if the new European Central Bank gains credibility and regulatory impediments are removed within Europe. However, if EMU is successful, it may mean that the US will have to compete more for global investment funds by paying a higher rate of interest. While such costs could be offset by the benefits of higher global GDP growth in a post-EMU world, these factors suggest that the US should be playing close attention to EMU's birth.

BUDGET QUIZ

<u>Question:</u> Based on the projections in OMB's Sequester Update Report, will a sequester be necessary this Fall?

<u>Answer:</u> Yes, but it would be a tiny sequester. Based on OMB's current estimates of House and Senate-passed appropriations bills, total crime funding will exceed the violent crime reduction limits by $1 million in budget authority in 1998.

- The Balanced Budget Act extended the Budget Enforcement Act (BEA) through 2002. As part of that extension, the Act set separate limits for defense and non-defense discretionary funding, and extended separate limits for violent crime reduction discretionary spending. The Act also wiped the pay-go scorecard clean of any surpluses for FY 1997 through 2002.

- The BEA requires OMB to submit a "Sequester Update Report". This report was included as part of OMB's Mid-Session Review. While crime funding is projected to be slightly above the BEA's limits, current Senate and House-passed appropriations bills provide defense and other non-defense discretionary spending within the limits. Although a few laws have been enacted since the Balanced Budget Act, these laws have not affected pay-go balances and no pay-go sequester is projected for this Fall.

CALENDAR

Tentative Senate Budget Committee fall schedule:
<u>September 30:</u> Task Force Meeting: International Affairs Accounts.

<u>October 21:</u> Impact of EMU on US Economy.

<u>October 23:</u> Europe's Long-Term Fiscal Challenge (Pensions): Lessons for the US.

<u>October 28:</u> EMU and NATO Enlargement: the Policy Debate.

<u>TBA:</u> DoD Underfunding and NATO/EMU Expansion.